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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

December 9, 1994

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

EX PARTE: CC Docket No. - 94-1 - Price Caps

Dear Mr. Caton:

The attached letter was delivered to the Commission today. Please incorporate this in the record of the above-captioned proceeding. Let me know if you have any questions.

Sincerely,

Whitney Hatch

Attachment

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Ms. Kathleen M. H. Wallman
Chief, Common Carrier Bureau
Federal Communications Commission
1919 M Street, NW
Washington, DC 20554

EX Parte - Price Caps - CC Docket No. 94-1

Dear Ms. Wallman:

During our recent ex parte meeting you requested additional information about an automatic adjustment mechanism for the price cap productivity offset. I hope the following is responsive.

We propose that a mechanism be adopted to automatically adjust the price cap productivity offset. A moving average calculation should be used to capture changes in the long-term growth of total factor productivity (TFP). This will pass on to consumers the benefit of any improvements in long-term productivity growth -- in much the same way a competitive market would.

Problems of Choosing a Fixed Offset

If a fixed offset is reviewed frequently:

- The Commission must become involved on a regular basis in an adversarial proceeding and expend considerable resources.
- LECs face the possibility that short-term productivity gains will be recaptured.
- This uncertainty substantially reduces the efficiency incentives of price cap regulation.

If the offset is fixed for a long period:

- There is no mechanism for passing through to consumers any LEC productivity improvements created in response to improved incentives.
- There is pressure to "pad" the offset to anticipate future productivity.

Automatic Adjustment of the Productivity Offset

Rather than estimate what future productivity growth may be, the Commission should establish an adaptive framework that would measure actual changes in productivity and

adjust the offset accordingly. This could be done by calculating the offset based on a moving average.

In a competitive market, productivity improvements are passed on to consumers with a lag. For example, if a company adopts an efficiency-improving innovation, that firm will benefit, relative to others in the industry. When the industry adopts the innovation and reduces average costs, market pressure will push prices down, passing the benefit of the innovation to consumers. This market process can be mimicked effectively through a suitably-designed moving average adjustment to the price cap productivity offset.

Features of an Effective Productivity Adjustment

1) The adjustment should be based on the difference between the growth in total factor productivity (TFP) for the industry and the growth in TFP for the economy as a whole. This calculation should be based on the methodology used by Christensen.

2) The adjustment should be automatic, without need for a formal proceeding by the Commission. TFP estimates could be prepared by the Bureau of Labor Statistics (BLS), by the Commission staff, or by a third party consultant.

3) Productivity results commonly display substantial year-to-year variation. Some of this variation is related to changes in utilization over the course of the business cycle. The moving average should be based on a sufficient number of annual observations to smooth out short-term fluctuations, so that the adjustment captures only changes in the long-term trend of productivity growth. GTE suggests that a five- to seven-year moving average would accomplish this goal.

4) There should be a sufficient lag in the incorporation of each year's data into the moving average to permit data to be prepared and the TFP estimate to be calculated. A lag of about two years would be practical for this purpose.

5) The combined effect of the moving average and the lag should replicate the time interval over which a competitive market would pass the benefit of productivity gains to consumers. Available data suggest that new telecommunications technology has been adopted over a period of 7 to 20 years (see Gilbert and Rohlfs, and data presented by Taylor). The parameters proposed here (5-7 year moving average and two year lag) would be consistent with the shorter end of this range.

Benefits of an Automatic Adjustment

1) Allows a price cap plan to be established for a long period, without the need for more frequent reviews. This in turn will allow LECs and other market participants to base their investment decisions on reasonable expectations concerning the parameters of the plan. This will provide incentives which will more effectively match those of a competitive market.

2) Allows productivity offset to be based correctly on historical evidence concerning growth in TFP, without the need to "pad" to allow for possible productivity increases over time. If productivity does improve as a result of improved incentives, the moving average will capture those changes. Eliminates speculation and debate over this issue, and replaces them with results.

3) Replicates the effect of a competitive market. The automatic adjustment would allow firms to retain transitory benefits, as an incentive to innovation, as they would in a competitive market. It would return the benefits of productivity improvements to consumers at the same rate a competitive market would do.

While I believe USTA is preparing more detailed proposals for such an automatic adjustment mechanism, I would be glad to answer any questions you might have about our proposed framework.

Sincerely,

Whitney Hatch

c: FCC Secretary
L. Belvin
K. Brinkmann
J. Casserly
J. Coltharp
D. Grosh
K. Levitz
G. Matise
R. Welch